

**IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMIER BLUE CROSS AND ITS AFFILIATES**

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

Patrick M. Fahey

March 31, 2004

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Table of Contents

	Page
Introduction	1
Purpose and Conclusions of Testimony	1
Qualifications	2
Role of Premera’s Compensation Committee of the Board of Directors; Executive Compensation Philosophy	3
Impact of Conversion on Executive Compensation	6
Public Benefits of Conversion	9
The “Compensation Assurances” in Premera’s Amended Form A	10
Verification of Pre-filed Direct Testimony	12

Introduction

Q. Please state your name, title, employer, and business address.

A. Patrick M. Fahey, Chairman of Regional Banking, Wells Fargo Bank. 999 Third Avenue, 47th Floor, MAC: P6540470, Seattle, Washington, 98104.

Q. What is your relationship to Premera Blue Cross?

A. I am an independent director of the Premera and Premera Blue Cross boards of directors. I have served on the Premera and Premera Blue Cross boards since October 1998. I also serve as Chair of the Compensation Committee, and as a member of the Executive and Governance Committees.

Purpose and Conclusions of Testimony

Q. What is the purpose of your testimony?

A. To provide an overview of the Board's role in setting Premera's executive compensation, and its oversight to ensure that such compensation is consistent with best practice in the health plan industry. I will also provide my views on the stock plan, which has been approved by the Premera board as well as compensation assurances that are part of our Form A.

Q. What are the primary conclusions to be drawn from your testimony?

A. There are four main conclusions. First, the Premera Board's overall executive compensation philosophy and its implementation are reasonable and appropriate. Second, the Board's Compensation Committee ("Committee") consists of committee members who are independent members of the board and no employee of Premera is a member of the committee. The committee's decisions about executive compensation are based upon market data provided by our external compensation expert and the advice and

1 counsel of that firm. Third, based upon the information provided to the full Board from
2 their independent experts, the Premera executive compensation program and the levels of
3 compensation are reasonable and competitive with comparable organizations in the health
4 care industry. Finally, the stock plan adopted by the Board and filed as part of Premera's
5 conversion proposal is also reasonable and appropriate and well within industry standards
6 for comparable companies. It is my understanding that the proposed stock program
7 includes limitations which are within industry standards or more restrictive than those
8 implemented in other recent Blue conversions.

9 **Qualifications**

10 **Q. Please summarize your educational background.**

11 A: I am a graduate of Seattle University, Pacific Coast Banking School, and the
12 Management Program of the University of Washington Graduate School of Business.

13 **Q. Please summarize your business background.**

14 A. I joined Seattle First National Bank in 1967 as a management trainee and
15 remained with the firm until 1981, attaining the position of Senior Vice President. In
16 1981, I joined Old National Bank of Washington as Regional Vice President for Western
17 Washington and became President and Chief Operating Officer of the bank in 1983. In
18 1988, I founded Pacific Northwest Bank, which merged with InterWest Bancorp in 1998.
19 At that time, I joined the Board of Directors and became Vice Chairman of Commercial
20 Banking for InterWest Bancorp. In 2000, InterWest Bancorp changed its name to Pacific
21 Northwest Bancorp. I was Chairman, President and Chief Executive Officer of that
22 entity and of the Bancorp's banking subsidiary, Pacific Northwest Bank. Wells Fargo
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1 recently acquired Pacific Northwest Bancorp and its subsidiaries, and I currently serve as
2 Chairman of Regional Banking for Wells Fargo.

3 **Q. Aside from your employer and Premera, what other organizations are you or
4 have you recently been active in?**

5 A. I currently serve, or have served, in a number of community activities including:
6 Seattle University, Board of Trustees; Washington State University, College Advisory
7 Board, School of Business and Economics; Columbia Tower Club (Past Chairman, Board
8 of Governors); Providence Foundation of Seattle (Past Chairman); Washington Bankers
9 Association (Past President); Pathways for Women (Co-Chairman of Capital Campaign);
10 Greater Seattle Chamber of Commerce (Past Trustee & Vice Chairman); Rainier Club
11 (Past Director & Treasurer); Washington Athletic Club (Past Member, Board of
12 Governors); YMCA of Greater Seattle (Past Director). I also serve on the Board of
13 Directors of Physicians Insurance, A Mutual Company.

14 **Role of Premera's Compensation Committee of the Board of Directors;**
Executive Compensation Philosophy

15 **Q. Please summarize the charter of the Compensation Committee.**

16 A. The Committee's overall purpose is to ensure that Premera has a compensation
17 system in place that attracts and retains high quality executive management; motivates
18 corporate officers and management to achieve Premera's business objectives; and aligns
19 the interest of key leadership with the long-term interests of the Company.

20 The Committee establishes Premera's general compensation philosophy and
21 oversees the development and implementation of the compensation program. We review
22 the competitiveness of the Company's executive compensation program, establish the
23 compensation of the Chief Executive Officer, and establish compensation ranges for
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1 other senior executives. The Committee also recommends the compensation of board
2 members, which is reviewed and approved by the full board. To assist us in
3 our deliberations related to compensation for the CEO, senior executives, and the board,
4 we use the services of an outside compensation consultant.

5 **Q. As Chair of the Compensation Committee, what are your main**
6 **responsibilities?**

7 A. I chair the Committee meetings, set the agenda, and ensure that we are operating
8 in accordance with appropriate rules of governance. With the approval of the Committee,
9 I take the lead in retaining any outside experts used by the Committee. I report on the
10 Committee's activities and recommendations to the full Board of Directors.

11 **Q. In addition to yourself, who are the other members of the Compensation**
12 **Committee?**

13 A. We have an experienced group of individuals, representing several important
14 perspectives. They are: Maria Pope, Vice President and General Manager, Wood
15 Products Division, of Pope & Talbot, Inc., a publicly traded forest products company;
16 Eleanor Andrews, President and Chief Executive Officer of the Andrews Group, which
17 provides facilities management, maintenance and operations services in Alaska; and John
18 Leinen, the former Executive Secretary-Treasurer of the Spokane Labor Council AFL-
19 CIO and former managing editor of Labor World publishing.

20 **Q. What procedures are in place to ensure that the Compensation Committee is**
21 **independent from Premera management?**

22 A. All of the Committee members are independent directors. This means that none
23 of us has a material relationship with the company. The Committee has the resources and
24 the authority to discharge its responsibilities, including the authority to select and engage

1 compensation consultants or other advisors we deem appropriate. In addition, all of our
2 key decisions take place in executive session, outside the presence of Premera
3 management. Topics discussed in executive session include the Chief Executive
4 Officer's pay and performance, compensation ranges for senior executives, and board-
5 related compensation issues.

6 **Q. What is the Compensation Committee's overall philosophy with respect to
7 executive compensation?**

8 A. As I mentioned earlier, our overarching objective is to attract and retain high
9 quality executive management; motivate corporate officers to achieve Premera's business
10 objectives; and align the interest of key leadership with the long-term interests of the
11 Company. We also want Premera's compensation program to be conservative and
12 reasonable for a company in the health plan industry.

13 To ensure that Premera's executive compensation program is competitive, we
14 review an analysis of compensation offered by a peer group of health plan industry
15 companies. Our peer group includes both non-profit and for-profit companies (including
16 public companies). We generally target the market median base compensation of our
17 peer group. We also remain open to paying above that range depending on the
18 experience of the executive and strategic needs of the company.

19 **Q. How does the Compensation Committee go about determining executive pay
20 for Premera's top executives?**

21 A. We use a nationally-respected outside compensation consultant, Mercer Human
22 Resource Consulting, which conducts a competitive market analysis for senior executives
23 each year. That analysis is based on market compensation data gathered from for-profit
24 and not-for-profit healthcare organizations that are comparable to Premera in revenue

1 size and business complexity. The data includes base salaries, total cash compensation,
2 and long-term incentives. We benchmark executive compensation against the data,
3 making adjustments for such factors as performance, experience, and comparability of
4 position. Based on the blended survey data of both the non-profit and for-profit sectors,
5 we generally set base pay ranges around market median. On average, the goal is to pay at
6 the median for executive positions. According to Mercer, for example, the compensation
7 of our Chief Executive Officer is at market median.

8 However, this isn't a case where you can blindly follow the median of the market.
9 The Committee also has to take into account trend data, company and individual
10 performance, individual growth and contribution, internal equity (how positions compare
11 to each other inside the company), and other factors. Market data is just one piece of
12 information that the Committee needs to assess. As I said earlier, actual salaries depend
13 on the experience of the executive and the strategic needs of the company.

14 **Impact of Conversion on Executive Compensation**

15 **Q. If Premera becomes a publicly traded company, what changes will the**
16 **Compensation Committee need to make to its member composition,**
independence from Premera management, or procedures?

17 A. Very few, if any, changes will be needed if Premera becomes a publicly traded
18 company. The Board of Directors of Premera has designed the Compensation Committee
19 Charter and committee membership composition to comply, to the extent appropriate,
20 with the provisions of the Sarbanes-Oxley Act and New York Stock Exchange
21 requirements and to be consistent with best practices. In many respects, the Premera
22 Compensation Committee is already using best practices for public companies. For
23 example, our Committee members are independent; we make important decisions in
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1 executive session (such as those related to CEO pay); and we retain an outside
2 compensation expert to advise us.

3 **Q. If Premera becomes a publicly traded company, what changes will the**
4 **Compensation Committee make to its compensation philosophy?**

5 A. The Compensation Committee has not recommended any change to Premera's
6 overall compensation philosophy as a result of the conversion. As in the past, the
7 Committee will exercise its fiduciary duty in setting compensation at levels that are
8 consistent with industry standards, and that will allow Premera to attract and retain high
9 quality talent.

10 **Q. Has the Compensation Committee approved an equity compensation plan**
11 **that will be deployed if Premera becomes a public company?**

12 A. The Compensation Committee did approve an equity compensation plan in
13 response to Commissioner Kreidler's instructions that such a plan should be reviewed as
14 part of the conversion process. Consistent with that directive, Premera filed a stock plan
15 in October 2003. The Compensation Committee later approved changes to the stock plan
16 which were filed on February 5, 2004 in response to discussions held with OIC staff and
17 their consultants in December 2003 and January 2004.

18 **Q. Please summarize the key components of the equity compensation plan.**

19 A. The equity plan the Board approved imposes a waiting period of a full twelve
20 months commencing on the date of the conversion before any officer or director may
21 receive any stock options or other form of equity. For the first three years after the initial
22 public offering ("IPO"), the Board has limited equity incentives for all employees and
23 directors to 7% of common shares outstanding at the time of the conversion and IPO.

24 The plan also contains limitations on the maximum grants of options and restricted stock

1 to executive management and other employees for the two years following the one year
2 waiting period.

3 **Q. What due diligence did the Compensation Committee conduct prior to**
4 **approving the equity compensation plan?**

5 A. We worked with our outside consultant, Mercer Human Resource Consulting, to
6 ensure that we had the information needed to make an informed decision regarding
7 Premera's equity plans. In October 2002, we asked Mercer to make a presentation to the
8 entire Board, which covered the compensation environment in publicly-traded
9 companies, the use of equity and the role of compensation committees and boards in
10 executive compensation matters. This was followed by a session with the Compensation
11 Committee where Mercer presented more detailed comparative data from Blue
12 conversions, mutual conversions and other health plans. We discussed equity programs
13 in general and how equity could be used at Premera. Based upon the discussion at this
14 meeting, Mercer prepared a draft equity strategy and presented it to the Committee at a
15 meeting held later in October 2002. Based upon those recommendations, Premera
16 proposed limitations on stock programs in Exhibit G-10 of its Form A filing in October
17 2002. Approximately one year later, after receiving direction that a more detailed plan
18 was expected by the Commissioner and the state consultants, the Committee again took
19 the matter of stock plans under consideration. At our meeting in October 2003, the
20 Committee reviewed a more detailed equity plan with Mercer, including maximum award
21 levels for specific employee groups. After considerable discussion, and after taking into
22 account the views of the state's consultants as expressed in their initial reports, we
23 developed the plan that was filed in October 2003. The Board made further changes to
24 the plan in the amended Form A filing dated February 5, 2004, which included changes

1 proposed by the OIC staff consultants during their discussions with Premera in December
2 2003 and January 2004. Based on comparative information reviewed, Premera's
3 proposed equity compensation plan as filed in February is more restrictive than that of
4 any other Blue Cross/Blue Shield plan that has converted to for-profit status.

5 **Q. To the best of your knowledge, is the executive compensation plan (including**
6 **equity compensation) that has been approved by the Compensation**
7 **Committee and the Board of Directors in keeping with best practices in the**
8 **industry?**

9 A. Absolutely. One of the Compensation Committee's over-riding objectives in
10 designing the plan was to operate in accordance with best practices. To achieve that
11 objective, we retained Mercer, one of the leading experts in the field, to help us develop
12 the plan, and as part of the conversion process, Towers Perrin, another leading expert,
13 reviewed the plan. Towers Perrin concluded that "Premera's executive compensation
14 philosophy is conservative and reasonable for a company in its industry...that philosophy
15 appears to guide the design, implementation and administration of the compensation
16 program in the past and post-conversion."

17 **Public Benefits of the Conversion**

18 **Q. From your perspective as board member, what are the potential benefits of**
19 **conversion?**

20 A. I see numerous benefits. The health insurance market in Washington is
21 competitive, and it is in everyone's best interest to ensure that Premera remains a vital
22 part of that market. The company is currently restrained in its ability to access capital,
23 but at the same time it must continue to make investments in systems and products to stay
24 competitive. To spread those costs across a wider base of customers, Premera needs to
grow. But the dilemma is that the Company's growth is limited because of its capital

1 position. A stronger capital surplus position will allow Premera to meet its obligations
2 without limiting its growth or its ability to compete. Having more capital will also allow
3 the company to invest in new products and improved customer service.

4 Of course, the other major benefit to Washington is that the conversion will create
5 a significant pool of funds that can be used to foster better healthcare for the residents of
6 our state, and Alaska as well. In the current environment of weak economic conditions
7 and a sizeable state budget deficit, we need those funds more than ever.

8 **The “Compensation Assurances” in Premera’s Amended Form A**

9 **Q. Are you aware of the Compensation Assurances that are part of Exhibit E-8**
10 **in Premera’s Amended Form A?**

11 **A. I am.**

12 **Q. One of the Compensation Assurances provides for a “Designated Board**
13 **Member” to sit on the Compensation Committee. (A Designated Board**
14 **Member is one that is elected from a slate nominated by the Foundations.)**
15 **What is your reaction to that?**

16 **A. While I believe that the Compensation Committee, as presently constituted, would**
17 **have been completely independent and committed to ensuring that the level of**
18 **compensation for the executives was the appropriate one, I have no problem with the**
19 **addition of the Designated Board Member and I would make sure that the person taking**
20 **that position is fully informed and involved in the compensation process. I further**
21 **believe that the addition of this Designated Board Member should give the Commissioner**
22 **even greater confidence that the compensation packages for the for-profit Premera will be**
23 **fair, competitive and in the best interests of the shareholders and members.**
24

1 **Q. Another of the Compensation Assurances establishes the "peer group" that**
2 **should be used by the Compensation Committee. What do you think of that**
3 **provision?**

4 A. The peer group identified in the Form A is our current peer group, with certain
5 changes recommended by PricewaterhouseCoopers (PWC), the state's compensation
6 consultant. The use of a peer group comprised of companies recommended by PWC
7 should give the Commissioner comfort that future compensation will be in line with an
8 appropriate peer group of companies.

9 **Q. The Compensation Assurances will be in place for a two year period. What**
10 **do you think of that time period?**

11 A. There are many factors that can change during the course of two years, so tying
12 the hands of the Compensation Committee beyond that time period would be unwise. It's
13 also important to remember that the Compensation Committee, consistent with its
14 fiduciary duty, will continue to have the advice of outside executive compensation
15 consultants, who will help us understand the on-going developments in compensation.
16 And we will continue to be guided by what I submit is a very prudent compensation
17 philosophy.

18 **Q. Does this conclude your testimony?**

19 A. Yes.
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